

August 16, 2006

MEMORANDUM TO: State Investment Council

FROM: William G. Clark s/*William G. Clark*(crb)
Director

SUBJECT: **Proposed Private Equity Investments in Gleacher Mezzanine Partners II and Lehman Crossroads Fund XVIII**

This due diligence memorandum is presented to the State Investment Council (the “Council”) pursuant to N.J.A.C. 17:16-69.12 (a) to report on two proposed private equity investments: a \$50 million commitment to Gleacher Mezzanine Partners II, and a \$50 million commitment to Lehman Crossroads Fund XVIII.

Please note that these investments will be authorized pursuant to Articles 69 and 90 of the Council’s regulations which became effective on June 20, 2005. The Gleacher Mezzanine Partners II investment will be considered a “Debt-related Investment” and the Lehman Crossroads Fund XVIII will be considered a “Venture Capital Investment” as defined under N.J.A.C. 17:16-90.2 (a).

The Alternative Investments Procedures adopted by the Council on January 20, 2005 require any potential alternative investment opportunities to be identified and initially evaluated by the Head of Alternative Investments of the Division (myself in an acting capacity) and the applicable Asset Class Consultant (Strategic Investment Solutions for private equity, or “SIS”) in coordination with the DOI Investment Committee (Ike Michaels acting as Deputy Director and myself).

As a result of internal and external sourcing, the DOI Investment Committee identified these proposed investments. As a result, SIS and Division staff proceeded to undertake extensive due diligence on these two proposed investments. We completed the same due diligence process as with all the other alternative investment opportunities presented to the Council.

Based on this due diligence, the Division has determined that each of the proposed investments meets the criteria for investments set forth in the Alternative Investment Procedures.

The investments that we are proposing focus on the mezzanine debt market (Gleacher Mezzanine Partners II) and the venture capital market (Lehman Crossroads Fund XVIII).

The general partner for *Gleacher Mezzanine Partners II* has successfully demonstrated the ability to construct balanced portfolios of mezzanine investments that can achieve superior returns in a variety of market environments. The fund will target superior returns through a combination of substantial capital appreciation and current income by making mezzanine investments primarily in private middle market companies, typically alongside reputable private equity firms. The principals have worked together for a decade making mezzanine investments and have developed a disciplined, repeatable process for executing, monitoring and exiting investments. The general partner will be investing a significant amount in the Fund, ensuring that the limited partners' interests are aligned with those of the general partner. The management fees are reasonable, and all the legal and economic terms associated with the partnership are fair and consistent with market standards.

Lehman Crossroads Fund XVIII (\$750 million) is a diversified fund investing across different private equity asset classes (small- and mid-cap buyout, large-cap buyout, venture and growth capital and special situations). While we believe that Lehman has strong expertise across the private equity spectrum, we are particularly attracted to Lehman's ability to access and invest in venture and growth capital investments. We have negotiated with Lehman to allow New Jersey's proposed allocation to this fund (\$50 million) to be invested solely in the venture and growth capital segment of the Fund, which is expected to comprise roughly 20%-30% of Lehman Crossroads Fund XVIII or \$150 million - \$225 million. This portion of Lehman Crossroads Fund XVIII will focus on seed capital, late stage and venture buyout investments. The general partner seeks to identify partnerships with successful investment teams, high quality deal flow and a proven ability to build companies. The general partner has a proven track record of executing its strategy and generating top-quartile returns as well as proven access and established relationships with top tier venture firms. The general partner has substantial capital committed to the Fund thus aligning our interests with those of the general partner. Again, we believe the management fees are reasonable, and all other legal and economic terms are fair and consistent with market standards.

A formal written due diligence report for each of the proposed investments was sent to each member of the Investment Policy Committee of the Council on August 9, 2006, and a meeting of the Committee was held on August 14, 2006. In addition to the formal written due diligence reports, all other information obtained by the Division on these two investments was made available to the Investment Policy Committee.

After review of the extensive due diligence, the Investment Policy Committee of the Council decided to report on these proposed investments to the full Council pursuant to Step 4 of the Alternative Investments Procedures. Under these procedures, the Council may adopt or otherwise act on this report.

We will work with representatives of the Division of Law and outside counsel to review and negotiate specific terms of the legal documents to govern each investment. In addition, each proposed investment must comply with the Council's "pay to play" regulation (N.J.A.C. 17:16-4). While we are confident that we will work through these issues, the potential exists that a successful resolution will not be reached with one or the other of these general partners.

We look forward to discussing these proposed private equity investments at the Council's August 22, 2006 meeting.

WGC:cae
Attachments